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# Defining the Duty: Attorneys' Obligations Under Rule 10b-5

CYNTHIA A. BEDRICK\*

## INTRODUCTION

"It is perhaps unfortunate that a lawyer's theoretical duty to justice and to the public good has been so totally overwhelmed by a duty of loyalty to a client, but this seems unlikely to change any time soon."<sup>1</sup> The legal profession has both public duties to society and private duties to advance the interests of its clients in the best way possible. Nowhere is the conflict between the two more evident than in the securities laws. The Securities Exchange Act of 1934<sup>2</sup> ("the Exchange Act") was enacted principally to protect the public from the many dangers of the securities markets, but the practical impact may not be as noble.

In *Rubin v. Schottenstein, Zox, & Dunn*, the Sixth Circuit Court of Appeals held that a law firm which both misrepresented material facts and made material nondisclosures was not liable to the investors that their clients defrauded because there was no reasonable reliance by the investors on the attorney's misrepresentations and no duty to disclose to the investors.<sup>3</sup> This case provides a prime example of the conflict between public and private duties. By focusing on the private duties of the attorney to protect client confidences and diligently pursue client objectives, attorneys are allowed to act in ways that are contrary to the general public duties of the Securities Acts: honesty, justice, and fairness.

This Note will show that the current approach to attorneys' liability for nondisclosures under section 10(b) of the Exchange Act<sup>4</sup> ("Section 10(b)" or "10(b)") is not enough. It allows attorneys to omit material facts (nondisclosure), lowers the reputation of the legal profession as a whole, and is inconsistent with the major goals of the Securities Acts,<sup>5</sup> which are to ensure fair and honest markets<sup>6</sup> and protect investors.

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1. Robert A. Prentice, *Locating the "Indistinct" and "Virtually Nonexistent" Line Between Primary and Secondary Liability Under Section 10(b)*, 75 N.C. L. REV. 691, 768 (1997) (footnote omitted).

2. 15 U.S.C. §§ 78a-78mm (1994 & Supp. III 1997).

3. 110 F.3d 1247, 1257 (6th Cir.), *vacated*, 120 F.3d 603 (6th Cir. 1997) (en banc), *rev'd on reh'g*, 143 F.3d 263 (6th Cir. 1998) (reversing the summary judgment for the defendants).

4. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b).

5. The use of the term "Securities Acts" in this case refers to both the Securities Act of 1933 ("Security Act") and the Securities Exchange Act of 1934 ("Exchange Act").

6. See Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (1994).

Part I of this Note presents an introduction to liability under Rule 10b-5 of the Exchange Act<sup>7</sup> ("Rule 10b-5" or "10b-5") and Section 10(b). Part II looks at the typical situations in which attorneys may be held liable under Rule 10b-5 and the various duty tests currently in use, their strengths and weaknesses, and how they incorporate policy concerns. Part III addresses the specific policy concerns both for and against expansion of attorneys' duties under Section 10(b), including the policy behind the Exchange Act, attorneys' ethical obligations, and liability under other areas of the Securities Acts. Finally, Part IV suggests a modification of the current tests to create a uniform test for all circuits which furthers the purpose of the Exchange Act.

### I. CURRENT SECTION 10(b) LIABILITY

This Part of the Note will provide an introduction to the basics of Rule 10b-5. These basics include the elements the plaintiff must prove to bring a private cause of action under Rule 10b-5. Also, the distinction between primary and secondary liability will be discussed. This is important because with the elimination of secondary liability,<sup>8</sup> an attorney must be found primarily liable to have violated Rule 10b-5.

Section 10(b) of the Exchange Act provides the basis for the anti-fraud litigation under the act. It makes it unlawful for any person "[t]o use or employ . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."<sup>9</sup> Rule 10b-5, which was enacted under the authority of Section 10(b), specifies a list of acts that are "manipulative devices" including "(1) [t]o employ any device . . . to defraud, (2) [t]o make any untrue statement of a material fact . . . or (3) [t]o engage in any act . . . which . . . would operate as a fraud . . . upon any person."<sup>10</sup>

Section 10(b) and Rule 10b-5 are the catch-all anti-fraud provisions of the Exchange Act. While there are considerable procedural and substantive elements to a 10b-5 cause of action,<sup>11</sup> a suit under Rule 10b-5 can be brought by any purchaser or seller of a security against anyone who uses manipulative devices in connection with the purchase or sale of a security.<sup>12</sup> A typical Rule 10b-5 suit involves a claim by an investor against the issuer of a security based on a decline in stock price caused by over-optimistic expectations about the future performance of the company or stock, failure to disclose negative facts about the company, or misrepresentations by the companies about their current performance. While issuers are usually the main defendants in these cases, liability can also fall on the

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7. Securities Exchange Act of 1934, Rule 10b-5, 17 C.F.R. § 240.10b-5 (1998).

8. See discussion *infra* Part I.B.

9. Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b).

10. 17 C.F.R. § 240.10b-5.

11. See discussion *infra* Part I.A.

12. See Robert J. Haft, *Liability of Attorneys and Accountants for Securities Transactions*, in *OPINIONS IN SEC TRANSACTIONS* 777, 783 (PLI Corp. Law & Practice Course Handbook Series No. B4-7099, 1995).

accountants, the underwriters, and, our focus here, the attorneys involved in the security transaction.

### A. Elements

While neither the Exchange Act nor the rule specifically authorizes one, a private cause of action has been recognized under Section 10(b) since 1946.<sup>13</sup> The Supreme Court acknowledged the private right of action in 1983, relying on almost forty years of lower court decisions.<sup>14</sup> Under current law, the plaintiff must prove seven elements to show the defendants are liable for a violation of Rule 10b-5. Rule 10b-5 has three sub-sections that involve different varieties of fraud.<sup>15</sup> Because suits against attorneys are generally brought under subsection (2), this will be discussed in detail. In order to state a case under Rule 10b-5(2), there must be (1) a misrepresentation, omission, or nondisclosure, (2) in connection with the purchase or sale of a security, (3) a duty to disclose, (4) scienter, (5) materiality, (6) reliance, and (7) injury.<sup>16</sup>

First, a distinction must be made between misrepresentations, material omissions, and nondisclosures<sup>17</sup> because suits under each have different basic elements. Misrepresentations occur when the defendant makes a false statement whereas omissions are when the defendant states partial truths.<sup>18</sup> Omissions occur when a defendant states part of a fact, but omits material information that is necessary to keep the revealed information from being misleading.<sup>19</sup> These two types of fraud are specifically prohibited in the language of Rule 10b-5.<sup>20</sup> Nondisclosures occur when the defendant fails to disclose material information in its entirety and are also actionable under 10b-5(2).<sup>21</sup> In order to satisfy the first element of Rule 10b-5, the

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13. See *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 514 (E.D. Pa. 1946).

14. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 380 (1983).

15. Rule 10b-5(1) and (3) will not be the focus of this discussion, but it should be noted that there are different requirements for those causes of action.

16. This formulation of the elements is one of several, listing anywhere from 4 to 7 elements. See Michael J. Kaufman, *Living in a Material World: Strict Liability Under Rule 10b-5*, 19 CAP. U.L. REV. 1, 2 (1990); Prentice, *supra* note 1, at 699; Kevin P. Roddy, *Money, Mail Fraud, and Malpractice: Attorney's Liability in Financial Transactions*, in MISERY, MALPRACTICE, AND MAIL FRAUD: LAWYERS' PROFESSIONAL LIABILITY IN THE 90's, at 341, 346 (ALI-ABA Course of Study, Oct. 17, 1991); Jerold S. Solovy et al., *Potential Liability of Attorney's in Securities Transactions*, in SECURITIES LITIGATION: 1987 PROSECUTION AND DEFENSE STRATEGIES 621, 626-27 (PLI Litig. & Admin. Practice Series No. 335., 1987).

17. The focus of this Note is nondisclosures, although some courts might refer to the withholding of information as omissions, and opinions do not always clearly distinguish between the three violations. Classifying between the three types can become important because the elements for a cause of action are altered in a nondisclosure claim. See *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972).

18. See Solovy et al., *supra* note 16, at 627-28.

19. See *id.* at 629.

20. The Rule states that "[i]t shall be unlawful . . . [t]o make any untrue statement . . . or to omit to state a material fact necessary in order to make the statements . . . not misleading." 17 C.F.R. § 240.10b-5 (1998).

21. See Solovy et al., *supra* note 16, at 629.

defendant must make either a material misrepresentation, omit a material fact, or completely fail to disclose a topic of material importance (nondisclosure).<sup>22</sup>

Secondly, the misrepresentation, omission, or nondisclosure must be in connection with the sale or purchase of a security. The "in connection with" language comes directly from the rule itself<sup>23</sup> and has been interpreted to mean everything from the information must be "reasonably calculated to influence the investing public"<sup>24</sup> to the fraud must touch the security.<sup>25</sup> A more widely accepted definition of the "in connection with" requirement relies on a contextual approach and requires the court to examine the transaction to determine whether the person claiming fraud was actually engaged in securities activity, and whether the investment activity was essential to the fraudulent scheme.<sup>26</sup> As a procedural requirement, there must also be a purchase or sale of a security.<sup>27</sup>

In order for the defendants to be liable they must have a duty to the investor. The duty element for misrepresentations is supplied by the common law. The Restatement (Second) of Torts states this duty as follows:

One who fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it, is subject to liability to the other in deceit for pecuniary loss caused to him by his justifiable reliance upon the misrepresentation.<sup>28</sup>

Because omissions make a representation false, the same common law duty applies.

In nondisclosure cases, however, the question of duty becomes difficult.<sup>29</sup> Courts have determined that there must first be a duty to disclose in order for the nondisclosure to be fraudulent.<sup>30</sup> The general approach to nondisclosures under Rule 10b-5 has been the traditional caveat emptor, absent a fiduciary relationship. The use of this approach allows attorneys to violate commonsense ideas of fairness and honesty in reliance on their private duties. The early common law found a duty in the very limited cases where a fiduciary relationship or privity existed.<sup>31</sup> The courts reasoned that when one party expects the information to be disclosed, the lack of disclosure is a fraudulent act. However, in more recent years, courts have used several different tests to determine when defendants have a duty to disclose.<sup>32</sup> Because of the wide variety of tests, very little is certain in the area of duties to

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22. *See id.* at 627-29.

23. 17 C.F.R. § 240.10b-5.

24. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 862 (2d Cir. 1968).

25. *See Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971).

26. For more information on the contextual analysis and the "in connection with" requirement generally, *see Texas Gulf Sulphur*, 401 F.2d at 860, and JAMES D. COX ET AL., SECURITIES REGULATION 686-87 (1997).

27. *See Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 755 (1975). The Court was, in part, affirming the *Birnbaum v. Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952), rule that the Second Circuit had followed for twenty-three years. *See Blue Chip Stamps*, 421 U.S. at 749. The Court relied on the policy of avoiding "a danger of vexatiousness" in litigation to limit the availability of Rule 10b-5 to purchasers and sellers. *Id.* at 739.

28. RESTATEMENT (SECOND) OF TORTS § 525 (1977).

29. For a detailed analysis of the duty question, *see infra* Part II.

30. *See Chiarella v. United States*, 445 U.S. 222, 228 (1980).

31. *See id.*

32. *See* discussion *infra* Part II.B.

disclose, except that a duty must be found in order for the defendant to be liable for nondisclosure under Rule 10b-5.

The fourth element of a cause of action under Rule 10(b)-5 is scienter. The Supreme Court in *Ernst & Ernst v. Hochfelder* determined that in order to be liable under Section 10(b), the defendant must have "a mental state embracing intent to deceive, manipulate, or defraud."<sup>33</sup> This changed the long existing rule that mere negligence could be the basis for Section 10(b) liability and began a trend of increased difficulty in bringing a successful Section 10(b) suit. While the Supreme Court has never specifically ruled on the issue, most courts have held that recklessness is enough to satisfy the scienter requirement.<sup>34</sup>

The fifth element is materiality. The Supreme Court defined materiality in *TSC Industries, Inc. v. Northway Inc.* as "[a]n omitted fact . . . [where] there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . . [and] the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder."<sup>35</sup> Under Rule 10b-5, the misrepresentation, omission, or nondisclosure must be material to the average investor; the standard does not change based on the subjective views of each individual. If the information (or lack thereof) would not have altered the "total mix" of information available to the investor, then it is not actionable no matter how egregious.<sup>36</sup>

Reliance is the sixth element of a successful cause of action under Rule 10(b)-5. In cases of misrepresentations and omissions, the plaintiff must show that the defendant's action induced them to purchase or sell the security.<sup>37</sup> However, if the case involves a nondisclosure, there is a presumption that the nondisclosure was relied upon. As the Court in *Affiliated Ute Citizens v. United States* stated, "All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision."<sup>38</sup> There is some question as to whether this can apply outside the face-to-face transaction context.

In the context of misrepresentations and omissions, plaintiffs often rely on methods other than individual reliance to ease their burden of proof on the reliance

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33. 425 U.S. 185, 193 n.12 (1976). In this case, the Court held that the defendant, Ernst & Ernst, was not liable for its negligent failure to use appropriate auditing procedures because it lacked the intent to defraud that was necessary in a Section 10(b) suit. *See id.* at 193. More specifically, the Court determined that Ernst & Ernst was negligent in its failure to discover the "mail" rule, a rule that only the president of the bank could open the mail of the bank. *Id.* at 215. The Court derived this intent component from the statute and the administrative history of Section 10(b). *See id.* at 201-14.

34. *See* *Trust Co. v. NNP, Inc.*, 104 F.3d 1478, 1490-91 (5th Cir. 1997); *Croy v. Campbell*, 624 F.2d 709, 715 (5th Cir. 1980); *Nelson v. Serwold*, 576 F.2d 1332, 1336-38 (9th Cir. 1978).

35. 426 U.S. 438, 449 (1976). This case defined materiality in the context of Rule 14a-9, but the definition has since been extended to Rule 10b-5. *See* *Basic Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988).

36. *See* *TSC Industries*, 426 U.S. at 449.

37. *See* *Latigo Ventures v. Laventhol & Horwath*, 876 F.2d 1322, 1325 (7th Cir. 1989).

38. 406 U.S. 128, 153-54 (1972).

elements. The "fraud on the market"<sup>39</sup> theory is the principle alternative to proving individual reliance. The "fraud on the market" theory states that the investor justifiably relied on the stock market and the idea that the market price is fairly set without any market manipulation.<sup>40</sup> Because the company's statements are presumed to be reflected in the price, the investors, in relying on that price, are indirectly relying on the statements. There are other arguments which plaintiffs may raise to help satisfy their reliance requirement including that they relied on the reputation of the firm when making their investment decision.<sup>41</sup>

Finally, an investor must show that the misrepresentation resulted in an actual injury.<sup>42</sup> Included in this requirement is that the price must have dropped (or risen in cases where the plaintiff sold the stock) because of the material misrepresentation, omission, or nondisclosure of the defendant.<sup>43</sup> The standard measure of damages is the difference in the price paid and the price at which the transaction would have been consummated absent the fraud.<sup>44</sup>

While all of these elements are necessary in order for the plaintiff to establish their cause of action, the duty element is the focus of suits against attorneys. Attorneys, under current law, can conceal misleading information as long as they owe no duty to the third party. This puts attorneys in the interesting situation of not being required to disclose information even when their ethical and other obligations would require it.<sup>45</sup>

### *B. Primary and Secondary Liability*

Another important distinction in Rule 10b-5 lawsuits is between primary and secondary liability. Before 1994, the majority of suits against attorneys were for secondary as opposed to primary liability.<sup>46</sup> Secondary (or aider and abettor) liability typically involved three elements: (1) a primary violation by another party, (2) the defendant had knowledge of the wrong, and (3) the defendant substantially

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39. Developed in the Ninth Circuit case *Blackie v. Barrack*, 524 F.2d 891, 906-08 (9th Cir. 1975), the theory has several variations in the different circuits. See, e.g., *Finkel v. Docutel/Olivetti Corp.*, 817 F.2d 356, 362-63 (5th Cir. 1987) (holding that the fraud on the market theory is not applicable under 10b-5(2)); *Peil v. Speiser*, 806 F.2d 1154, 1156, 1160-62 (3d Cir. 1986); *Harris v. Union Elec. Co.*, 787 F.2d 355, 367 n.9 (8th Cir. 1986); *Teamsters Local 282 Pension Trust Fund v. Angelos*, 762 F.2d 522, 529 (7th Cir. 1985).

40. See *Basic*, 485 U.S. at 241-48.

41. If an investor uses the reputation theory, it puts the firm in the difficult position of having to try and argue that it does not have a good reputation in the community. See Solovy et al., *supra* note 16, at 642, for a more detailed discussion. Courts have also developed various tests to determine if reliance is reasonable. See, e.g., *Molecular Tech. Corp. v. Valentine*, 925 F.2d 910, 918 (6th Cir. 1991) (describing the Sixth Circuit's eight factor test).

42. See *Feldman v. Pioneer Petroleum Inc.*, 813 F.2d 296, 301 (10th Cir. 1987).

43. See *Robbins v. Koger Properties, Inc.*, 116 F.3d 1441, 1447 (11th Cir. 1997).

44. See *Alna Capital Assocs. v. Wagner*, 758 F.2d 562, 566 (11th Cir. 1985).

45. See *infra* Part II.B.

46. See Ben D. Orlanski, *Whose Representations Are These Anyway? Attorney Prospectus Liability After Central Bank*, 42 UCLA L. REV. 885, 891, 896 (1995); Patricia Blanchini, Note, *The Statement Someone Else Makes May Be Your Own: Primary Liability Under Section 10(b) After Central Bank*, 71 ST. JOHN'S L. REV. 767, 770-72 (1997).

assisted in the violation.<sup>47</sup> Using these criteria, it was easier to prove that defendant attorneys had assisted issuer fraud by directly communicating with investors and failing to disclose what the issuer had omitted. Once a case had been made against an issuer, it was not very hard to establish liability against the attorney on an aider and abettor theory.<sup>48</sup>

Establishing primary liability of an attorney involves proving the elements discussed in Part I.A. of this Note. However, many courts have not adequately developed the distinction between primary and secondary liability. For most courts, that distinction was not an issue until the Supreme Court in *Central Bank v. First Interstate Bank* ruled that there was no statutory basis for secondary liability under Rule 10b-5.<sup>49</sup> The Court's decision overruled thirty years of precedent and made the distinction between primary and secondary liability of major importance.<sup>50</sup> While the law is not entirely clear, after *Central Bank*, it is apparent that attorneys can still be held liable for their own misrepresentations under a theory of primary liability. However, courts have been split over when liability will attach to attorneys for the misstatements of others.<sup>51</sup>

## II. THE DUTY DEFINED

This Part of the Note is devoted to a discussion of the duty element in detail. First, I will discuss the typical situations in which an attorney may be held liable under Rule 10b-5. Next, I will discuss the various duty tests and how attorneys may be held liable under each of the tests.

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47. See Prentice, *supra* note 1, at 707.

48. See Blanchini, *supra* note 46, at 771-72.

49. 511 U.S. 164, 191 (1994).

50. Prior to *Central Bank*, aider and abettor liability in 10b-5 actions had been widely recognized. See *Farlow v. Peat, Marwick, Mitchell & Co.*, 956 F.2d 982, 986 (10th Cir. 1992); *Levine v. Diamanthuset, Inc.*, 950 F.2d 1478, 1483 (9th Cir. 1991); *K. & S Partnership v. Continental Bank*, 952 F.2d 971, 977 (8th Cir. 1991); *Schatz v. Rosenberg*, 943 F.2d 485, 496 (4th Cir. 1991); *Fine v. American Solar King Corp.*, 919 F.2d 290, 300 (5th Cir. 1990); *Schlifke v. Seafirst Corp.*, 866 F.2d 935, 947 (7th Cir. 1989); *Schneberger v. Wheeler*, 859 F.2d 1477, 1480 (11th Cir. 1988); *Moore v. Fenex, Inc.*, 809 F.2d 297, 303 (6th Cir. 1987); *Cleary v. Perfectune, Inc.*, 700 F.2d 774, 777 (1st Cir. 1983); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Monsen v. Consolidated Dressed Beef Co.*, 579 F.2d 793, 799-800 (3d Cir. 1978); *Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 680 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969).

51. See *Walco Investments, Inc. v. Thenen*, 881 F. Supp. 1576, 1582-83 (S.D. Fla. 1995) (denying an attorney's motion for summary judgment based on false statements made by the client but contained in a solicitation document prepared by the attorney); *Employers Ins. v. Musick, Peeler, & Garrett*, 871 F. Supp. 381, 388-89 (S.D. Cal. 1994) (denying a motion to dismiss a complaint alleging 10b-5 liability against attorneys for drafting a prospectus containing misrepresentations and omissions). *But cf.* *Anixter v. Hane-Stake Prod. Co.*, 77 F.3d 1215, 1226 (10th Cir. 1996) (holding that an accountant must actually make a misleading statement to be liable); *In re JWP, Inc. Sec. Litig.*, 928 F. Supp. 1239, 1256 (S.D.N.Y. 1996) (holding that a defendant may not be liable under 10(b) unless it actually made a misrepresentation); *In re MTC Elec. Tech. Shareholders Litig.*, 898 F. Supp. 974, 987 (E.D.N.Y. 1995) (same). Attorneys can still be held liable in Securities Exchange Commission ("SEC") enforcement actions under aider and abettor theories. See *infra* text accompanying notes 158-59.



### A. Typical Situations

There are five typical situations in which attorneys are found liable. The first of these involves intentional fraud and deceit that could have been done by anyone, but the wrongdoer happens to be an attorney. An illustration of this type of 10b-5 violation is *SEC v. Jakubowski*.<sup>52</sup> In *Jakubowski*, the defendant attorney was held liable for attempting to use conversion rights that were unavailable to him.<sup>53</sup> Jakubowski tried to receive the benefits of these rights through fraud and manipulation.<sup>54</sup>

The second situation involves one of the principal targets of Rule 10b-5, insider trading.<sup>55</sup> There are two theories of insider trading, traditional and misappropriation.<sup>56</sup> Traditional insider trading involves persons who breach a fiduciary duty to the corporation by trading on inside information.<sup>57</sup> Typically, these insiders of the corporation include management and directors of the corporation, but can include attorneys under the "temporary insider" theory.<sup>58</sup> This theory states that a person can be a temporary insider when the person becomes connected with the management of the corporation.<sup>59</sup> The temporary insider must have a relationship with respect to the conduct of the corporation, the corporation must have an expectation that the insider will keep the information confidential, and the insider must have given assent to the expectation.<sup>60</sup> These temporary insiders could include attorneys for corporations and, therefore, the attorneys would violate 10b-5 if they traded on inside information.

The second theory of insider trading that includes attorneys is the misappropriation theory. The Supreme Court recently accepted this theory of insider trading in *United States v. O'Hagan* and held an attorney liable for insider trading.<sup>61</sup> The misappropriation theory states that if a person steals information in violation of a fiduciary duty owed to the source of the information and then trades on the information, they have violated Rule 10b-5.<sup>62</sup> In *O'Hagan*, an attorney used confidential information obtained by representing an acquiring company in a tender

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52. No. 94 C 4539, 1997 WL 156544 (N.D. Ill. Mar. 31, 1997), *aff'd*, 150 F.3d 675 (7th Cir. 1998).

53. *Id.* at \*1-5.

54. *See id.*

55. While originally the SEC and Congress focused on section 16 of the Exchange Act and the full disclosure legislation to combat insider trading, *see COX ET AL.*, *supra* note 26, at 775-76, in *Cady, Roberts & Co.*, 40 S.E.C. 907 (1961), and *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), Section 10(b) and Rule 10b-5 were expanded to cover this conduct. This has continued until the present day.

56. *See United States v. O'Hagan*, 521 U.S. 642, 651-52 (1997); *see also Texas Gulf Sulphur Co.*, 401 F.2d at 847-58 (discussing insider trading generally).

57. *See O'Hagan*, 521 U.S. at 651-52.

58. *See Dirks v. SEC*, 463 U.S. 646, 655 n.14 (1983).

59. *See id.*

60. *See id.*; *SEC v. Ingram*, 694 F. Supp. 1437, 1439-40 (C.D. Cal. 1988).

61. 521 U.S. at 653.

62. *See id.* at 652.

offer to purchase stock in the target company.<sup>63</sup> The attorney breached a duty of confidentiality between him and his employer in violation of Rule 10b-5.<sup>64</sup> After *O'Hagan*, an attorney may be held liable under either a traditional or misappropriation theory of insider trading.

The third situation involves an attorney's opinion letters. An opinion letter is a letter drafted by the attorney that states that they worked on the transaction and it is fair to the parties involved. Attorneys draft opinion letters for any number of transactions and may be held liable for their own misrepresentations and reckless analysis. In *Ackerman v. Schwartz*, the defendant, Schwartz, was an attorney for the promoters of a fraudulent tax shelter.<sup>65</sup> He wrote an opinion letter that stated that investors would be entitled to certain credits and reductions from the investment, but also contained certain untrue "facts" about the investment.<sup>66</sup> The Seventh Circuit held that the attorney could be held liable even though he owed no duty to the individual investors because he allowed the promoters to release his letter to the investors' representatives.<sup>67</sup> Attorneys have also been held liable in situations where investors could reasonably be expected to rely on their opinion letters.<sup>68</sup>

The fourth situation where attorneys may be held liable is in the drafting of a prospectus or other materials for an issuer. This liability involves attorneys in two different roles. First, when the attorney is an officer or director of the issuer, as well as the drafter of the prospectus, the attorney, as well as the other officers and directors, can be held liable for the misrepresentations in the prospectus as a control person of the issuer.<sup>69</sup> The second situation occurs when the attorney is not an officer of the issuer. These cases are more controversial,<sup>70</sup> but several attorneys have been held liable for drafting false and misleading prospectus documents under the theory that they failed to investigate the claims in the prospectus or that they breached a duty to the investors.<sup>71</sup> Failing to disclose can also involve failure to

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63. *Id.* at 647-48.

64. *See id.* at 660.

65. 947 F.2d 841, 843 (7th Cir. 1991).

66. *See id.*

67. *See id.* at 848.

68. *See id.*; *Kline v. First Western Gov't Sec., Inc.*, 24 F.3d 480 (3d Cir. 1994); *Alter v. DBLKM, Inc.* 840 F. Supp. 799, 808 (D. Colo. 1993).

69. *See* 15 U.S.C. § 78t(a) (1994); *Bomarko, Inc. v. Hemodynamics, Inc.*, 848 F. Supp. 1335, 1339 (W.D. Mich. 1993) (stating that the director who served as general counsel for a corporation, reviewed corporate announcements, and drafted communications could be a control person and, therefore, liable under securities law).

70. *See* Ted J. Fafilis, *Lawyer's Exposure to Liability in Securities Practice*, in SECURITIES FOR NON-SECURITIES LAWYERS 613, 628 (ALI-ABA Course of Study, Oct. 10, 1996).

71. *See* *Beard v. Sachnoff & Weaver, Ltd.*, 941 F.2d 142, 145 (2d Cir. 1991); *Walco Investments, Inc. v. Thenen*, 881 F. Supp. 1576, 1582 (S.D. Fla. 1995); *Employers Ins. v. Musick, Peeler, & Garrett*, 871 F. Supp. 381, 388-90 (S.D. Cal. 1994); *In re Flight Transp. Corp. Sec. Litig.*, 593 F. Supp. 612, 617 (D. Minn. 1984).

In addition to the approaches discussed in this Note, some courts have held that attorneys have a limited duty to investigate. The Third Circuit stated, "[T]his court has adopted a limited duty to investigate and disclose when, by the drafter's omission, a public opinion could mislead third parties." *Kline*, 24 F.3d at 491. This duty is limited to situations where the attorney does not have a reasonable belief that information in its opinion letter or other documents is true (amounting to

amend and correct documents that the attorney has previously submitted to the Securities Exchange Commission ("SEC") or potential investors.<sup>72</sup>

The final situation in which attorneys may be held liable is for failing to disclose material facts which are not connected with the documents. In *Rubin v. Schottenstein, Zox, & Dunn*, the attorney defendants allowed two investors to invest in their client, a corporation, even though they knew prior lenders would look poorly upon new capital infusions.<sup>73</sup> Their failure to disclose to the potential investors that any additional credit would cause the company's creditors to seize the company's assets caused the investors to complete the transaction and lose their investment.<sup>74</sup>

### B. Different Duty Tests

Under current 10b-5 doctrine, even with all the other elements of a cause of action present, concealing misleading information is not actionable absent a duty to speak.<sup>75</sup> The duty element is thus particularly important in the case of attorneys because under the current law, attorneys have very limited duties to anyone besides their clients. For example, most attorneys do not have a fiduciary relationship with their investors and, therefore, lack a duty to them.<sup>76</sup> Courts have applied several different duty tests to determine when attorneys (or other defendants) may be held liable. The scope of liability turns on the breadth (or narrowness) of the duty. Therefore, a close examination of the various duty tests provides insight on what elements are common to all the tests and where changes could be made.

The Supreme Court has never specifically addressed the duty an attorney owes to third parties in the 10b-5 context. Therefore, the thirteen courts of appeals have taken widely varying approaches depending on the facts of the particular cases, the circuit in which the case is brought, and characteristics of the particular defendant and transaction.

The Fourth, Fifth, and Seventh Circuits have followed the typical, narrow approach stating that in nondisclosure cases, attorneys owe a duty to third parties only when they owe a fiduciary duty to the third party under non-securities law.<sup>77</sup> Under this test, a defendant may be held liable for failure to disclose only in those instances where there is a fiduciary relationship between the defendant attorney and the plaintiffs. A fiduciary relationship is one that involves "confidence . . . reposed

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recklessness). *See id.*

72. *See In re Time Warner, Inc.*, 9 F.3d 259, 260 (2d Cir. 1993); *Greenfield v. Heublein, Inc.*, 742 F.2d 751, 751 (3d Cir. 1984); *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1307 (5th Cir. 1977); *Ross v. A.H. Robbins, Co.*, 465 F. Supp. 904, 905 (S.D.N.Y.), *rev'd*, 607 F.2d 545 (2d Cir. 1979).

73. 143 F.3d 263, 266 (6th Cir. 1998) (en banc).

74. *See id.*

75. *See Chiarella v. United States*, 445 U.S. 222, 228 (1980); Michael J. Kaufman, *Living in a Material World: Strict Liability Under Rule 10b-5*, 19 CAP. U.L. REV. 1, 17 (1990).

76. *See Chapter VII Other Causes of Action*, 50 BAYLOR L. REV. 761, 795 (1998).

77. *See, e.g., Fortson v. Winstead, McGuire, Sechrest & Minick*, 961 F.2d 469, 472 (4th Cir. 1992); *Abell v. Potomac Ins. Co.*, 858 F.2d 1104, 1118 (5th Cir. 1988); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 495-96 (7th Cir. 1986).

on one side and . . . [a] resulting superiority and influence on the other.”<sup>78</sup> In *Schatz v. Rosenberg*, the defendant attorneys represented a purchaser who paid for two companies owned by the plaintiffs with promissory notes.<sup>79</sup> The defendants knew that their clients were bankrupt, but failed to disclose this information to the seller.<sup>80</sup> The attorneys were found to be not liable to the plaintiffs because “no fiduciary or confidential relationship existed between the two parties.”<sup>81</sup>

The most common example of the existence of a fiduciary or confidential relationship occurs when there are transactions with shareholders. If an insider—a director, a member of management, or a majority shareholder—in a corporation does business with a minority shareholder, that insider has a fiduciary duty to the shareholder.<sup>82</sup> Therefore, many attorneys will not be held liable because they do not have a similar relationship with third parties, although they will be held liable to their own clients. While this approach supplies a fair amount of certainty, it is also almost an impossibly high burden for plaintiffs to meet with respect to attorneys and may not be in line with the purpose of the Exchange Act.<sup>83</sup>

The certainty allows easy prediction, but may have the “principal weakness . . . [of] allow[ing] egregious wrongdoing to go unpunished and serious fraud-inflicted injuries to go uncompensated.”<sup>84</sup> This occurs because the attorneys have perpetuated or allowed their clients to deceive innocent plaintiffs, the clients have disappeared or filed for bankruptcy, and the attorneys have no duty to the victims. It is also far from the certainty that some courts make it out to be. The common law has supplied duties to speak in at least thirteen situations, not all of which are applicable to securities law, but which illustrate that the fiduciary approach is not uniformly accepted.<sup>85</sup> These exceptions are based on the idea that the general rule “reflects ‘dubious business ethics.’”<sup>86</sup> Included among them are the duty not to tell

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78. *United States v. Reed*, 601 F. Supp. 685, 706 (S.D.N.Y.) (describing a fiduciary relationship), *rev'd on other grounds*, 773 F.2d 477 (2d Cir. 1985).

79. 943 F.2d 485, 488 (4th Cir. 1991).

80. *See id.*

81. *Id.* at 490.

82. *See Speed v. Transamerica Corp.*, 99 F. Supp 808, 828-29 (D. Del.), *modified*, 100 F. Supp. 461 (D. Del. 1951).

83. *See infra* Part III.A.

84. Prentice, *supra* note 1, at 727-28. Although this author was referring to a narrow test for primary as opposed to secondary participation, the reasoning is applicable to the duty question.

85. *See id.* at 720 n.129.

86. *Id.* (quoting W. PAGE KEETON ET AL., PROSSER AND KEATON ON THE LAW OF TORTS § 106, 737-38 (5th ed. 1984)).

half truths,<sup>87</sup> the duty to update,<sup>88</sup> the duty to correct,<sup>89</sup> the duty to speak if one has a superior position or superior knowledge,<sup>90</sup> and the duty to disclose where failure to do so would strike a normal person as unethical.<sup>91</sup>

A second approach, the one followed by the Second, Sixth, and Ninth Circuits, is to look at who has the superior information in determining if one party has a duty to disclose.<sup>92</sup> If one party has information that the other does not have (or could not obtain) access to, this can be a factor to determine if the party must disclose the information in order to avoid unfairness.<sup>93</sup> This idea is closely related to common law fraud concepts as explained in *FDIC v. W.R. Grace & Co.*<sup>94</sup> The court in that case stated that "when the seller has without substantial investment on his part come upon material information which the buyer would find either impossible or very costly to discover himself, then the seller must disclose it."<sup>95</sup>

This theory has been most widely used in securities cases where the attorneys prepared the offering circular or document with the nondisclosure. In *Molecular Technology Corp. v. Valentine*, the attorneys were held liable for failing to disclose in an offering circular prepared for a merger that certain shares of the corporation were in escrow (among other things).<sup>96</sup> The court stated that "a reasonable jury could find that Synder [(the attorney)] knew certain information in the amended offering circular was misleading and that Synder had a duty to disclose that information to investors such as the plaintiffs under 10(b)/rule 10b-5."<sup>97</sup> While the court used direct contacts language,<sup>98</sup> it based its decision on the fact that Snyder

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87. See *Dennis v. Thomson*, 43 S.W.2d 18, 23 (Ky. 1931); *Smith v. Pope*, 176 A.2d 321, 324-25 (N.H. 1961); *Uptegraft v. Dome Petroleum Corp.*, 764 P.2d 1350, 1353 (Ok. 1988).

88. See *Tempo Tamers, Inc. v. Crow-Houston Four, Ltd.*, 715 S.W.2d 658, 669 (Tex. App. 1986). While many circuits have limited the duty of attorneys to those with which the attorneys have a fiduciary relationship, these same courts have found that a duty to update exists. This means that when an attorney makes affirmative statements that later become false, the attorney has an obligation to correct these misleading impressions. See *Kline v. First W. Gov't Sec., Inc.*, 24 F.3d 480, 491-92 (3d Cir. 1994).

89. See *Weiner v. Quaker Oats Co.*, 129 F.3d 310, 318 (3d Cir. 1997); *Fitzgerald v. McFadden*, 88 F.2d 639, 642 (2d Cir. 1937).

90. See *Prentice*, *supra* note 1, at 697 & n.129.

91. See *Hand v. Dayton-Hudson*, 775 F.2d 757, 759 (6th Cir. 1985); *Southern Land Dev. Co. v. Meyer*, 159 So. 245, 246 (Ala. 1935); *Berger v. Security Pac. Info. Sys. Inc.*, 795 P.2d 1380, 1383 (Colo. Ct. App. 1990); *Weintraub v. Krobatsch*, 317 A.2d 68, 71 (N.J. 1974); *George Cohen Agency, Inc. v. Donald S. Perlman Agency, Inc.*, 114 A.D.2d 930, 932 (N.Y. App. Div. 1985); *Ollerman v. O'Rourke Co.*, 288 N.W.2d 95, 107 (Wis. 1980).

92. See, e.g., *Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 653-54 (9th Cir. 1988); *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del.), *modified*, 100 F. Supp. 461 (D. Del. 1951).

93. See *Rachman Bag Co. v. Liberty Mutual Ins. Co.*, 46 F.3d 230, 237 (2d Cir. 1995) (state law); *Central States Stamping Co. v. Terminal Equip. Co.*, 727 F.2d 1405, 1409 (6th Cir. 1984) (same).

94. 877 F.2d 614 (7th Cir. 1989).

95. *Id.* at 619.

96. 925 F.2d 910, 918 (6th Cir. 1991).

97. *Id.*

98. See *infra* text accompanying note 100.

drafted the merger documents and had knowledge of the false information.<sup>99</sup> This approach is certainly more inclusive than the strict fiduciary approach, but it lacks specific guidelines and may be too broad in its coverage. Also, never allowing one to take advantage of superior knowledge for business gain goes against a basic tenet of the United States market economy.

There is another theory of duty, also espoused by the Sixth Circuit, that seeks to hold responsible persons who had direct contact with the investors. The court in *SEC v. Coffey* stated that “[a] duty to disclose naturally devolve[s] on those who [have] direct contacts with ‘the other side.’”<sup>100</sup> The courts have interpreted this approach broadly to apply whenever a defendant drafts a prospectus or other document. This can be seen from *SEC v. Washington County Utility District*, where the court stated that direct contacts did not need to involve physical contact, but instead occurred if the attorney furnished information which was misleading because of nondisclosure.<sup>101</sup> This provides a somewhat circular test. The courts state that there is no duty to disclose in a document unless there are direct contacts, while at the same time the direct contacts are supplied by the document, so there will always be a duty.<sup>102</sup>

In an older line of cases, the Seventh Circuit focused on the reasonable expectations of the investors. In *Kohler v. Kohler*, the court stated that a duty to disclose under Rule 10b-5 should not extend beyond that required by the “exercise of fair and honest business practices.”<sup>103</sup> Courts have looked at six factors to determine what constitutes fair and honest business practices: (1) the nature of the dealings between the parties, (2) the plaintiff’s knowledge of the business, (3) the plaintiff’s business acumen, (4) the plaintiff’s initiation of the transaction, (5) the degree which the plaintiff was concerned with obtaining full disclosure, and (6) the plaintiff’s familiarity with financial information concerning the corporation.<sup>104</sup> In dealings with unsophisticated plaintiffs, this idea of fairness could require more honesty from attorneys. Although up until now, this analysis has been used only in closely held corporations, it provides a basic theory that if there were expectations of disclosure, the failure to disclose might constitute fraud and, therefore, a violation of Section 10(b).<sup>105</sup> There is an element of fairness and a focus on honest business transactions in this test that pervades some business litigation.

Another way of interpreting the expectations test is to focus on whether, through their representation of clients, the attorneys are impliedly representing that the

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99. *See Molecular Tech. Corp.*, 925 F.2d at 917-18.

100. 493 F.2d 1304, 1315 (6th Cir. 1974).

101. 676 F.2d 218, 223 (6th Cir. 1982). In this case, the defendant was also an officer who had signed the prospectus, however, later courts lowered the standard. *See Atlantis Group Inc. v. Rospatch Corp.*, Nos. 1:90-CV-805, 1:90-CV-806, 1992 WL 226912 (W.D. Mich. July 8, 1992).

102. *See Orlanski*, *supra* note 46, at 915.

103. 319 F.2d 634, 641 (7th Cir. 1963).

104. *See Steven A. Fishman, Duty to Disclose Under Rule 10b-5 in Face-to-Face Transactions*, 12 J. CORP. L. 251, 267 (1987).

105. This idea is similar to the theory espoused in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972). In that case, the Court looked to what a reasonable person would consider important in determining whether the plaintiff was entitled to the presumption of reliance. *See id.* at 153-54.

transaction is fair and honest. This theory argues that the investor is basing investment decisions on the reputation of the firm and the actions of the attorneys.<sup>106</sup> Although closely related to reliance and the direct contacts test, this branch of the expectations test focuses on the investor's expectation that the attorney would not be involved in deceitful transactions.<sup>107</sup> This relates to the description of attorneys as "reputational intermediaries: someone paid to verify another party's information."<sup>108</sup>

The Eleventh Circuit Court of Appeals has developed a three-pronged test focusing on accountant's liability that may be useful to analyze the potential liability of attorneys. In *Rudolph v. Arthur Anderson & Co.*, the court relied on whether the accountant's information was superior to the investor's, whether the cost to the accountant of revealing the information was minimal, and whether the cost to the investors of keeping the information secret was large.<sup>109</sup> The court used these factors to hold Arthur Anderson liable under Rule 10b-5 aider and abettor liability for failing to "blow the whistle" on its client who was intending to use investor's funds for items other than those listed in the private placement memorandum.<sup>110</sup>

The final test is one developed in the Ninth Circuit case, *White v. Abrams*, which has come to be known as the flexible duty test.<sup>111</sup> While this test is no longer followed by the Ninth Circuit, it is followed on occasion by other circuits.<sup>112</sup> This test applies five factors to the securities transactions to determine whether a duty to disclose exists and the defendants will be liable. The factors are (1) the relationship of the defendant to the plaintiff, (2) the defendant's access to the information as compared to the plaintiff's access, (3) the benefit that the defendant derives from the relationship, (4) the defendant's awareness of whether the plaintiff was relying upon the relationship in making his investment decision, and (5) the defendant's activity in initiating the securities transaction in question.<sup>113</sup> In *Roberts v. Peat, Marwick, Mitchell & Co.*, the court looked to three of the factors to determine that a law firm was not liable for its failure to include information that another investor owned an interest in the property in a title opinion.<sup>114</sup> The three factors were (1) that the law firm was retained only with respect to specific issues,

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106. See Prentice, *supra* note 1, at 733.

107. Phrased another way, visible participation by an attorney in the fraudulent scheme, even though no actual contact with the investor occurs, can lead investors to believe the transaction is legal and fair. See *id.* at 743-46.

108. Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 289 (1984).

109. 800 F.2d 1040, 1043-45 (11th Cir. 1986).

110. See *id.* at 1045-56. There is the possibility that with the demise of aider and abettor liability under Rule 10b-5 that this test may be outdated. See discussion *supra* Part I.B.

111. 495 F.2d 724, 735-36 (9th Cir. 1974).

112. See *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1570 (9th Cir. 1990) (en banc) (rejecting the flexible duty test because it embraces a negligence standard); Haft, *supra* note 12, at 793; see also *Arthur Young & Co. v. Reves*, 937 F.2d 1310, 1330 & n.26 (8th Cir. 1991) (applying the factors of the flexible duty test).

113. See *Hollinger*, 914 F.2d at 1570 n.9.

114. 857 F.2d 646, 654 (9th Cir. 1988).

(2) the plaintiff had equal access to the information, and (3) that the law firm did not initiate the transaction.<sup>115</sup>

The flexible duty test has been criticized because parties are unable to determine in advance if a duty exists, and because the duty varies based on the nature of the plaintiff.<sup>116</sup> While an element of predictability is useful to keep the markets running smoothly, these two concerns can be said to apply to several other securities laws.<sup>117</sup>

### III. REASONS FOR AND AGAINST EXPANDING CURRENT LIABILITY

Current doctrine, under which attorneys are liable for omissions only in a narrow range of cases, has both support and opposition.<sup>118</sup> First, the purpose of the Exchange Act under which the rule was enacted and the intent of Congress must be examined. Next, an examination of attorney's ethical obligations shows arguments both for and against expansion of the liability provisions. Finally, a look at liability for non-attorney professionals under the other provisions of the Exchange Act, as well as attorney's liability under both the Securities and Exchange Acts, supports stronger standards that would not allow attorneys to be a part of deceitful transactions.

#### *A. The Purpose of the Act*

The purpose of the Exchange Act is stated in section 2: "For the reasons hereinafter enumerated, transactions in securities . . . are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, . . . to insure the maintenance of fair and honest markets in such transactions . . ."<sup>119</sup> From the statutory language and extensive judicial interpretation, the purpose of the Exchange Act has often been more broadly perceived to be to protect investors from

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115. *See id.*

116. *See Fishman, supra* note 104, at 273.

117. For example, in private placement under section 4(2) of the 1933 Act, 15 U.S.C. § 77(d) (1994), the SEC would not even issue opinion letters, and instead relied on vague judicial-made doctrine to define a "sophisticated purchaser" and the amount of information that needed to be made available to such purchasers. *See Gregory K. Miller et al., Exemptions from Securities Act Registration: Section 4(2), Regulation D, Rule 144A and Regulation S Offerings, in DOING DEALS 1999: UNDERSTANDING THE NUTS AND BOLTS OF TRANSACTIONAL PRACTICE 203, 205 (PLI Corp. Law & Practice Course Handbook Series No. B0-006V, 1999).* In 1972, the SEC enacted a safe harbor rule, Rule 144, 17 C.F.R. § 230.144 (1998). In order to rely on the statutory exemption, an issuer must still deal with the vague definitions and blurry lines.

118. *See Fishman, supra* note 104, at 329 (arguing that courts should require a duty to disclose in all face-to-face transactions based on a relationship that results in a justifiable expectation of disclosure); Prentice, *supra* note 1, at 720-22 (arguing that more duty exceptions should be recognized); *see also* Fafilis, *supra* note 70, at 619-20 (stating the traditional fiduciary duty approach).

119. Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b (1994).



fraudulent and dishonest practices,<sup>120</sup> and to provide for full and fair disclosure of information in the securities market.<sup>121</sup> The Exchange Act has both mandatory disclosure<sup>122</sup> and anti-fraud provisions<sup>123</sup> to enact these goals. As one court stated, "[a] fundamental purpose, common to securities regulation statutes, is to substitute the philosophy of full disclosure for a philosophy of caveat emptor and to achieve a high standard of business ethics in the securities industry."<sup>124</sup> These interpretations of the purpose of the Exchange Act call for a broad reading of the provisions of Section 10(b), more protections for investors, and, therefore, higher standards for attorneys.

Another purpose, although not specifically listed in the Act, which has been relied on by the judiciary is the desire to prevent frivolous litigation.<sup>125</sup> The Private Securities Litigation Reform Act of 1995<sup>126</sup> contains several provisions which illustrate this purpose, including the new rules concerning class actions.<sup>127</sup> The desire to prevent frivolous litigation would lead to higher standards for plaintiffs wanting to bring suit and may be inconsistent with higher standards for attorneys. The legislature desires to preserve and protect the reputation of the courts and to continue to keep them available for substantial claims and redresses.<sup>128</sup> The court has relied on this purpose in several key decisions including *Blue Chip Stamps v. Manor Drug Stores*, when it stated "that litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and in kind from that which accompanies litigation in general."<sup>129</sup> This purpose behind the Securities Acts supports an argument against higher standards for attorneys because the higher standard would entail more litigation that could in part be frivolous.

### *B. Professional Responsibilities*

A second factor that weighs into which duty to require of attorneys is the standards of the legal profession as a whole. Attorneys, as members of a profession, have certain duties and obligations to clients, courts, and the public at large. The

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120. See *United States v. Haddy*, 134 F.3d 542, 549-50 (3d Cir. 1988).

121. See *Tcherepnin v. Knight*, 389 U.S. 332, 335 (1967).

122. See Regulation S-K, 17 C.F.R. § 229.301 (1998).

123. See, e.g., 15 U.S.C. § 78j(b) (1994); Rule 10b-5, 17 C.F.R. § 240.10b-5 (1998).

124. *Chelsea Assocs. v. Rapanos*, 376 F. Supp. 929, 939 (E.D. Mich. 1974), *aff'd*, 527 F.2d 1266 (6th Cir. 1975).

125. See *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 739 (1975).

126. Pub. L. No. 104-67, 109 Stat. 737 (codified in scattered sections of 15 U.S.C.). In 1995, Congress passed reforms to both the Securities and Exchanges Acts that were largely designed to prevent the problems that were perceived with the rise of meritless class action litigation in the securities context. See *id.*

127. See *id.* § 101, 109 Stat. at 737-49.

128. See STAFF OF SENATE SUBCOMM. ON SEC. OF COMM. ON BANKING, HOUSING & URBAN AFFAIRS, 103D CONG., REPORT ON PRIVATE SECURITIES LITIGATION 108 (1994); Joel Seligman, *The Merits Do Matter*, 108 HARV. L. REV. 438, 445-48 (1994).

129. 421 U.S. 723, 739 (1975). The case is discussed further *supra* text accompanying note 27.

model codes for professional responsibility,<sup>130</sup> the Multistate Professional Responsibility Examination,<sup>131</sup> and the character and fitness elements of the bar exams are all requirements to ensure that the legal profession upholds the highest standard of honesty and fairness. Attorneys are officers of the court and, as such, must represent the truth and fairness that are inherent in that institution. In fact, there are severe sanctions for those attorneys who fall below acceptable standards of conduct.<sup>132</sup>

The preamble to the Model Rules of Professional Conduct sets out the expectations for attorneys. The Preamble states in relevant part:

[1] A lawyer is a representative of clients, an officer of the legal system and a public citizen having special responsibility for the quality of justice.

....  
[4] A lawyer's conduct should conform to the requirements of the law, both in professional service to clients and in the lawyer's business and personal affairs. . . .

....  
[5] . . . [A] lawyer should seek improvement of the law, the administration of justice and the quality of service rendered by the legal profession.<sup>133</sup>

These paragraphs set out the goals for attorneys in both their professional and personal conduct and show that they should be held to the highest standards possible. "[E]ven the law profession itself realizes that the courts are setting a scandalously low standard for the conduct of corporate attorneys and that something needs to be done to begin raising the level of expected behavior."<sup>134</sup> An example of low behavior of attorneys that is tolerated by the courts would be the original *Rubin v. Schottenstein, Zox, and Dunn* decision where the attorneys were allowed to misrepresent their clients to innocent investors.<sup>135</sup>

More specifically, Rule 1.6 of the Model Rules of Professional Conduct specifically addresses an attorney's duty to disclose client's information. Rule 1.6 allows attorneys to reveal a client's information "to the extent the lawyer reasonably believes necessary . . . to prevent the client from committing a criminal act that the lawyer believes is likely to result in imminent death."<sup>136</sup> However, there was a great debate in the drafting of the Model Rules because a large contingent of the American Bar Association ("ABA") wanted to change the words to read "to prevent

130. See MODEL CODE OF PROFESSIONAL RESPONSIBILITY (1997); MODEL RULES OF PROFESSIONAL CONDUCT (1997). The Model Code was the generally accepted ethical guideline before the enactment of the Model Rules. Some states, including Georgia, Nebraska, and Texas still use parts of the Model Code. See STEPHEN GILLERS & ROY D. SIMON, JR., REGULATION OF LAWYERS: STATUTES AND STANDARDS tbl. III, 938-39 (1996).

131. This is an exam given by the National Conference of Bar Examiners to test the ethics of potential members of the bar. The exam is required to be taken by the law students in 47 states to be admitted to the practice of law. See NATIONAL CONFERENCE OF BAR EXAM'RS, THE MULTISTATE PROFESSIONAL RESPONSIBILITY EXAMINATION, 1999 INFORMATION BOOKLET 1-2 (1999).

132. See MODEL RULES OF PROFESSIONAL CONDUCT Rules 8.1-8.5 (1997).

133. *Id.* pmbl.

134. Prentice, *supra* note 1, at 766 n.339.

135. See *supra* text accompanying note 3; see also COX ET AL., *supra* note 26, at 1022-23.

136. MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.6.

the client from committing a criminal or fraudulent act that the lawyer reasonably believes is likely to result in death or substantial bodily harm, or in substantial injury to the financial interests or property of another."<sup>137</sup> This shows support, although not fully accepted in the legal profession,<sup>138</sup> for allowing client information to be revealed for the protection of the public at large. In the securities realm, this could create a duty for attorneys to disclose information if it is likely to result in fraudulent activity with significant harm to innocent investors.

The Model Code of Professional Responsibility went even further in Disciplinary Rule 7-102(B), which states:

A lawyer who receives information clearly establishing that: (1) His client has . . . perpetrated a fraud upon a person or tribunal shall promptly call upon his client to rectify the same, and if his client refuses or is unable to do so, he shall reveal the fraud to the affected person or tribunal . . .<sup>139</sup>

This is a mandate that requires attorneys to rectify their clients' fraud as long as doing so will not violate attorney-client privilege.

While there are several rules that allow the attorneys to reveal limited information in certain circumstances, the largest obstacle to increasing the duty of attorneys to disclose fraud or material nondisclosures to investors is their duty to their clients. One of the methods developed to ensure that clients reveal all information necessary to present the best case possible for their defense is attorney-client confidentiality.<sup>140</sup>

The securities industry has to some extent attempted to set higher ethical standards for its bar. The SEC has long admitted that it "does not have the resources to investigate every instance in which a public company's disclosure is questionable."<sup>141</sup> Therefore, the attorneys and other securities professionals are responsible, at least in part, for policing the system. This policing function needs to be weighed against the client's interest to allow maximum protection of the system and the clients. Because of the large responsibility placed on the securities bar,<sup>142</sup> "[t]he right to appear and practice before this Commission as an attorney is, like membership in the bar itself, a privilege burdened with conditions."<sup>143</sup> An

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137. *Id.* (Revised Final Draft, June 30, 1982).

138. Currently, New Jersey and Wisconsin have adopted Rule 1.6 as proposed in their state codes of attorney's ethics, rather than using the language in the Model Rules. *See* NEW JERSEY RULES OF PROFESSIONAL CONDUCT Rule 1.6 (1998); WISCONSIN RULES OF PROFESSIONAL CONDUCT Rule 20:1.6 (1998).

139. MODEL CODE OF PROFESSIONAL RESPONSIBILITY DR 7-102(B) (1997).

140. *See id.* Canon 4.

141. *Private Litigation Under the Federal Securities Laws: Hearings Before the Subcomm. on Banking, Housing, & Urban Affairs*, 103d Cong. 113 (1993) (statement of William R. McClucas).

142. These responsibilities are described as the "onerous tasks . . . peculiarly dependent on the probity and the diligence of the professionals who practice before it . . . [and which the] investing public must take on faith." James R. Doty, *Regulatory Expectations Regarding the Conduct of Attorneys in the Enforcement of the Federal Securities Laws: Recent Development and Lessons for the Future*, 48 BUS. LAW. 1543, 1543 (1993).

143. Morris Mac Schwebel, 40 S.E.C. 347, 371 (1960).

alternate approach to any judicial changing of the standards is to have the securities bar set its own standards.<sup>144</sup>

### *C. Other Professionals' Responsibilities*

At this point, an examination of accountants' liability under Section 10 is helpful to demonstrate what standard should be used for attorneys. "[T]he Private Securities Litigation Reform Act of 1995 adds Section 10A to the [Exchange] Act, imposing a duty upon accountants to search for material instances of illegality during the audit process and report them to management and, if necessary, the SEC."<sup>145</sup> If an accountant discovers illegal activity by a client that is likely to have a material impact upon the financial statements, the accountant has an affirmative duty to report this activity to the management of the corporation, the board of directors, and, if the appropriate officials do nothing to rectify the situation, the SEC.<sup>146</sup>

Accountants and attorneys are both professionals who share major responsibilities for the accurate preparation and disclosure of the Exchange Act requirements.<sup>147</sup> Accountants also have a professional code of ethics, which is similar, although not identical, to the attorneys' code.<sup>148</sup> However, accountants do not generally have close ties to their clients and their duties have generally been assumed to be towards the public as opposed to specific clients.<sup>149</sup> Still, raising the standard for one professional group supports the argument in favor of stricter standards across the board.

### *D. Attorney Liability in Other Sections of the Securities Acts*

Another area that might provide illustrations of what duty attorneys owe the public is the other provisions of the Security Act and the Exchange Act. Under section 11 of the Securities Act, a broad range of people may be held liable for material false statements made in a registration statement.<sup>150</sup> Included in the

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144. See Doty, *supra* note 142, at 1555.

145. COX ET AL., *supra* note 26, at 676.

146. See Alan S. Fox, *Auditor's Responsibility Under Section 10A of the Private Securities Litigation Reform Act*, in SECURITIES LITIGATION 1998, at 693, 696 (PLI Corp. Law & Practice Course Handbook Series No. B0-0033, 1998); Andrew W. Reiss, Note, *Powered by More Than GASS: Section 10A of the Private Securities Reform Act Takes Accounting Profession for a New Ride*, 25 HOFSTRA L. REV. 1261, 1265 (1997).

147. See *supra* text accompanying note 142.

148. See AMERICAN INST. OF CERTIFIED PUB. ACCOUNTANTS, CODE OF PROFESSIONAL CONDUCT (1988).

149. See Doty, *supra* note 142, at 1547-48.

150. Securities Act of 1933 § 11, 15 U.S.C. § 77k(a) (1994). The Securities Act was intended to regulate offerings by issuers and initial public offerings, while the Exchange Act focused on regulation of trading, the exchanges, and the markets. See Securities Act of 1934 §2, 15 U.S.C. § 78b (1994); Securities Act of 1933 §§ 5-6, 15 U.S.C. §§ 77e-77f (1994 & Supp. III 1997). Section 11 of the Securities Act imposes civil liability on account of false registration statements. 15 U.S.C. § 77k(a).

category of people that may be held liable are the issuer, signers of the registration statement, main officers and directors, underwriters, and all experts, including accountants and attorneys.<sup>151</sup> In *Escott v. Barchris Construction Corp.*, the United States District Court for the Southern District of New York discussed the due diligence defense to section 11 violations.<sup>152</sup> Due diligence is the standard to which professionals are held. It imposes an affirmative duty on professionals to perform a reasonable investigation before their beliefs that there are no false statements in the registration statement can be found to be reasonable.<sup>153</sup>

In *Escott*, the attorneys of the issuer, the underwriters, and the accountants were all held liable for their failure to perform a reasonable investigation under the circumstances.<sup>154</sup> The court went further to state that one of the defendants, Grant, who was an attorney and a director, would face a higher degree of due diligence because he was an attorney. The court argued that this would not set an "unreasonably high standard" but would "require a check of matters easily verifiable."<sup>155</sup> This is just one of the many instances where the Securities Act gives attorneys an affirmative duty to protect investors, perhaps even at the expense of their clients.<sup>156</sup> This serves to keep the standards of the legal profession high, as well as protect attorneys from liability. Courts have used this decision to impose affirmative duties on attorneys to investigate the accuracy of offering statements.<sup>157</sup>

Another area, which shows a continued desire of the SEC and the courts to regulate attorneys, is the ability of the SEC to bring aider and abettor actions under Section 10(b) of the Exchange Act. While the private aider/abettor cause of action under Section 10(b) has been disallowed under *Central Bank of Denver v. First Interstate Bank of Denver*,<sup>158</sup> the SEC still has the ability to prosecute secondary participants in securities violations, which tend to be accountants and attorneys.<sup>159</sup>

### *E. Other Policy Concerns*

A final policy concern is the broadening of attorneys' responsibilities and obligations beyond that which was intended by the drafters of the Securities and Exchange Acts. While this relates to the purpose for which the statute was enacted, it also goes to one of the main concerns of securities regulation, the over-regulation, in some people's opinion, of the securities market. There is a line of scholarship that states that the mandatory disclosure provisions and excessively detailed

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151. See Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1994).

152. 283 F. Supp. 643, 682-84 (S.D.N.Y. 1968).

153. See 15 U.S.C. § 77k(a).

154. See *Escott*, 283 F. Supp. at 682-703.

155. *Id.* at 690.

156. Due diligence also serves as protection for the attorneys, so that the information they are releasing is accurate.

157. See *Felts v. National Account Sys. Ass'n*, 469 F. Supp. 54, 67 (N.D. Miss. 1978).

158. 511 U.S. 164 (1994).

159. See *supra* Part I.B.

regulations of the SEC are unnecessary for several reasons.<sup>160</sup> First, the Securities Acts were enacted with the goal of protecting investors at a time when individual investors dominated the market.<sup>161</sup> In recent years, there has been a trend towards the institutionalization of the market and the argument follows that the large institutions that dominate the market now do not need the extensive protections that the SEC and Congress have placed on the market. However, this argument ignores the roughly fifty percent of investors who are not institutions.<sup>162</sup>

Another argument against increased regulation in the securities market has to do with the Efficient Market Hypothesis ("EMH"). The EMH states that the information about a corporation is already reflected in the price of its securities before investors can make a profit on it.<sup>163</sup> The EMH appears in three forms: weak, semi-strong, and strong. The weak and semi-strong theories are widely accepted and state that previous price information and all currently available public information is incorporated into the price.<sup>164</sup> The strong theory states that all information, public or not, is incorporated into the price.<sup>165</sup> While not widely accepted, the proponents of this theory believe that extensive regulation of the securities industry is unnecessary because all the information about the stock and company is already incorporated into the price of the stock.<sup>166</sup> This supports an argument against increased regulation because regulation will not add anything to protect investors in the securities market. If all the information is already incorporated into the price, the disclosure requirements are unnecessary, as are insider trading laws.<sup>167</sup>

A third argument against extending the scope of attorneys' duties and the regulation as a whole of the securities industry is an argument about competition. As the market becomes increasingly global, the securities markets around the world will have to compete for capital, as well as the jobs and opportunities that accompany it.<sup>168</sup> The United States has the most burdensome regulations in the entire world, and the most costly.<sup>169</sup> Therefore, as global opportunities increase, foreign issuers, as well as U.S. companies, will turn towards foreign markets where

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160. See Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 692-707 (1984). But see Dale Arthur Oesterle, *The Inexorable March Toward a Continuous Disclosure Requirement for Publicly Traded Corporations: "Are We There Yet?"*, 20 CARDOZO L. REV. 135 (1998) (arguing in favor of a more organized continuous disclosure rule).

161. See Jerry W. Markham, *Protecting the Institutional Investor—Jungle Predator or Shorn Lamb?*, 12 YALE J. ON REG. 345, 346-50 (1995).

162. See COX ET AL., *supra* note 26, at 28 (citing N.Y.S.E. FACT BOOK 1995, FEDERAL RESERVE BOARD "FLOW OF FUNDS" 57 (1995)).

163. See Merritt B. Fox, *The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities*, 97 MICH. L. REV. 696, 732 n.86 (1998); Ronald J. Gilson & Reiner H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 552 (1984).

164. See Gilson & Kraakman, *supra* note 163, at 555-56.

165. See *id.*

166. See *id.* at 552.

167. There are, however, arguably other reasons for the disclosure requirements.

168. See James L. Cochrane et al., *Foreign Equities and U.S. Investors: Breaking Down the Barriers Separating Supply and Demand*, 2 STAN. J.L. BUS. & FIN. 241, 241-44 (1996).

169. See *id.* at 243-44.

they can raise capital with less expense and time. If more regulation is added to the already complicated U.S. system, it could worsen the problem and lead to a loss of the predominance of the U.S. capital markets in the world.

Finally, an argument which occurs everywhere from securities law to constitutional law is the concern that the judiciary is legislating. The actual text of Section 10(b) and Rule 10b-5 in no place mentions a private right of action, let alone attorneys' liability under such a suit. The judicial gloss on Rule 10b-5 has become lengthy and confusing and some scholars are wondering if it has anything at all to do with the original intent of Section 10(b).<sup>170</sup>

#### IV. REMEDIES

With an abundance of tests for duty, it is not clear when attorneys will be held liable for their actions, and in the process, investors are not being adequately protected. In order to fulfill the purpose of the Exchange Act, the tests for duty need to be modified. The current law needs uniformity to adequately protect investors. The question remains how to best accomplish the goals outlined in Part III with the tests available in Part II. By examining the current tests in light of these important issues, a combination of the elements of several of the tests, resulting in a two-part analysis, seems to yield the best results. Also, any duties that attorneys do have to third parties must be balanced against their professional responsibilities to their clients.

This proposed approach, the direct fairness test, calls for a two-part analysis. First, the court examines whether the defendant meets the direct contacts analysis of the Sixth Circuit.<sup>171</sup> Direct contacts require examining the transaction to see the attorney's role in the deal, interaction with investors, and level of deceit involved. The Sixth Circuit has stated that "[d]irect contacts may take many forms. An accountant or lawyer, for instance, who prepares a dishonest statement is a primary participant in a violation even though someone else may conduct the personal negotiations with a securities purchaser."<sup>172</sup> To determine whether the contacts are sufficient to satisfy the first half of the direct fairness test, the court examines the contacts between the parties, the nature of the contacts and their duration. The analysis turns on whether the defendant is sufficiently connected with the transaction to support 10b-5 liability.

If the direct contacts portion of the analysis is satisfied, the court then uses a multi-factor test, similar to the reasonable expectations and flexible duty tests used in various circuits to determine whether the actions of the defendant are intrinsically

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170. For an in depth discussion of the problems of the federal common law associated with Rule 10b-5, see Edward A. Fallon, *Section 10(b) and the Vagaries of Federal Common Law: The Merits of Codifying the Private Cause of Action Under a Structuralist Approach*, 1997 U. ILL. L. REV. 71.

171. See *supra* text accompanying notes 100-01.

172. SEC v. Coffey, 493 F.2d 1304, 1315 n.24 (6th Cir. 1974); see also Rubin v. Schottenstein, Zox & Dunn, 143 F.3d 263, 267 (6th Cir. 1998) (en banc) ("A person undertaking to furnish information which is misleading because of a failure to disclose a material fact is a primary participant.") (quoting SEC v. Washington County Util. Dist., 676 F.2d 218, 223 (6th Cir. 1982)).

fair. Because the direct contacts test is satisfied, the defendant has a stronger duty towards the investing public than if the direct contacts test is not satisfied. These contacts require applying a duty test that is more inclusive than traditional fiduciary duty tests. If, however, the direct contacts analysis is not satisfied, the defendant has a lesser duty to the investors and other potential plaintiffs.

The defendant has a duty to the investing public based on whether, looking at the totality of the circumstances, the defendant's actions are fair to both parties in the transaction. This is a moral fairness based on the expectations of conduct in business and in society. The direct fairness test places an emphasis on the reasonable expectations of the investor while looking at the defendant's reputation and actions. By emphasizing reasonable expectations, the direct fairness test will not allow an investor with completely unreasonable expectations to recover. To evaluate whether the conduct is fair, some of the factors from the reasonable expectations and flexible duty tests can be used,<sup>173</sup> including the benefit to the defendant, the defendant's awareness of the plaintiff's reliance, the defendant's role in initiating the deal, and the requirements in "an exercise of fair and honest business practices."<sup>174</sup> However, the ultimate question is: Are the defendant's actions fair and reasonable in the situation? Using this analysis, the defendant has a duty to be fair and act as a reasonable attorney and; if they do not do so, they have violated their duty.

There may be several problems in adapting the direct fairness test to all transactions since its previous use has been limited to face-to-face transactions. However, several other areas of law focus on the expectations of reasonable people<sup>175</sup> and fairness. Case law can be used to establish what a reasonable investor can expect from securities professionals and, conversely, the standard of care that a reasonable attorney must use. This solution does not provide immediate certainty, but it is a step towards increasing the responsibilities of attorneys by creating a standard more in line with their professional integrity. By using the direct contacts analysis to determine what level of duty arises out of a transaction, the defendants are not faced with unlimited liability. In addition, the use of a reasonable expectations/fairness factor becomes more appropriate because it is more likely that the plaintiff relied on the attorney, the firm, or its reputation and that the defendant should be responsible for the loss suffered in connection with that fraud. Also, the direct fairness test, by focusing on the fairness of the transaction and the defendant's actions, does not allow attorneys to escape their public duties by relying on their private obligations. This test is limited to attorneys and other professionals with obligations to the public because of the special responsibilities their professions place on them.

However, if an attorney does not satisfy the direct contacts analysis, there has to be a stronger relationship found than the general public duties based on intrinsic fairness. In the case with no direct contacts, there is a balancing test where the court weighs the public duties of the attorney with the private duties owed to the clients.

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173. See *supra* text accompanying notes 104, 113.

174. *Kohler v. Kohler Co.*, 319 F.2d 634, 641 (7th Cir. 1963).

175. See generally RESTATEMENT (SECOND) OF TORTS §§ 283-84 (1977) (concept of a reasonable man).



The burden of proof in this case falls on the plaintiff to show that the violation of public duties outweighs the interests of the particular client. Factors to consider in this balancing test include the nature of the attorney's conduct, the expectations of a reasonable investor (what would a typical investor expect an attorney to tell him), and the client's expectations of confidentiality.

Using the direct fairness test, attorneys are still liable to those investors to whom they owe a fiduciary duty, but if the attorney demonstrates direct contacts and an intent to deceive, they have greater obligations to the investing public. These obligations are based on the intrinsic fairness question and do not allow intentional misconduct to go unpunished. If, however, the attorney does not have direct contacts, the public and private duties of the attorney have to be balanced to determine if the duty to the public clearly outweighs the duty to the particular client.<sup>176</sup>

The direct fairness test is superior to relying on the traditional fiduciary duty approach that is very limited and hardly ever imposes liability on attorneys. This direct fairness test is also better than the superior information or direct contacts approaches which have little guidance and can be adopted so that liability for attorneys would be never ending. The direct fairness test is also superior to the reasonable expectations and flexible duty tests because it reduces the confusion and factors. The test has two parts which the court can use to determine if the defendant acted fairly given all the circumstances because attorneys have a responsibility to act fairly towards the public.<sup>177</sup>

#### CONCLUSION

By examining the current tests and their ambiguities as well as the policy reasons for holding attorneys to a higher standard of conduct, it becomes apparent that a new standard of duty needs to be formulated. A uniform duty test across the United States will end the controversy about what duties attorneys have and will provide more certainty in the securities industry. The two-part direct fairness test satisfies these concerns and brings attorney's legal obligations in line with their ethical obligations.

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176. To summarize, the proposed test has two parts. Did the defendant satisfy the direct contacts analysis as applied by the Sixth Circuit? If yes, the attorney or other professional has a duty to act fairly towards the public. To determine whether the defendant's actions are fair, look at (1) the factors in the reasonable expectations test and the flexible fairness test, (2) concepts of a reasonable man based on case law developed concerning what a reasonable lawyer would do, and (3) intrinsic fairness.

If the defendant does not meet the direct contacts analysis, the attorney's duty to her client generally prevails, although this duty must be tempered by the attorney's responsibilities to the public. The burden is on the plaintiff to show that the defendant's duty to the public clearly outweighs her duty to her client in this case.

177. See *supra* Part III.B.